THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

NUMBER 392 **FEBRUARY 2006**

In short the 1920s were an era of world-wide credit expansion. Its most spectacular phase was the large-scale financing of inflated security and real estate values, especially in the United States. Such overcapitalised values were not reflected in the price level indices, which has generated confusion. Both Lauchlin Currie and Friedman and Schwartz have insisted, as have many others, that there was no inflation in the 1920s, since "prices" did not rise.

— Melchior Palyi, *The Twilight of Gold, 1914–1936*, 1972

SPOTTING INFLATION AND DEFLATION

Since Benjamin Bernanke's nomination by President Bush to succeed Alan Greenspan at the helm of the Federal Reserve, it has been widely reported that Bernanke had fixed his earlier professional career as a professor of economics upon the study of the cause or causes of the 1930s Great Depression, with the intent to make sure that this will never happen again.

At a conference in 2002 honoring Milton Friedman's 90th birthday, he expressed contrition on behalf of the Federal Reserve: *"Regarding the Great Depression, you are right, we* [The Fed] *did it. We are very sorry. But thanks to you, we won't do it again."*

Wondering about Mr. Bernanke's academic research, we took a closer look at his earlier writings and contemporary speeches. We learned that he did *"groundbreaking research on how declining asset prices and weakened banks can choke off new lending and economic growth, and how the mistakes of the Federal Reserve compounded the catastrophe."*

America's Great Depression was by far the greatest economic and financial disaster in history. Yet it strikes us that the discussion in the United States has been stuck in the assertion that the Fed's failure to ease its reins fast enough was key to the savage asset and price deflation that followed during the 1930s.

The question of what may have gone wrong during the prior boom to cause the Depression has always been discarded as beside the point, with the argument that the extraordinary price stability prevailing in the 1920s represented conclusive evidence of the absence of any inflationary influences.

For most American economists, the verdict of Milton Friedman and A.J. Schwartz at the end of their *Monetary History of the United States, 1867–1960*, published in 1963, about the causes of the Great Depression, is virtual dogma. And so it is for Mr. Bernanke. To quote Friedman:

> *The stock market boom and the afterglow of concern with World War I inflation have led to a widespread belief that the 1920s were a period of inflation and that the collapse from 1929–1933 were a reaction to that. In fact, the 1920s were, if anything, a time of relative deflation: From 1923–1929 — to compare peak years of business cycles and to avoid distortions from cyclical influences — wholesale prices fell at the rate of 1% per year and the stock of money rose at the annual rate of 4% per year, which is roughly the rate required to match expansion of output. The business cycle expansion from 1927–1929 was the first since 1881–1893 during which wholesale prices fell, even if only a trifle, and there has been none since.*
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> *The monetary collapse from 1929–1933 was not an inevitable consequence of what had gone on before. It was the result of the policies followed during those years. As already noted, alternative policies that could have halted the monetary debacle were available throughout those years. Though the Federal Reserve proclaimed that it was following an easy monetary policy, in fact, it followed an exceedingly tight monetary policy.*

The 1920s were, indeed, a period of extraordinary price stability. In particular, under the influence of Milton Friedman, it became axiomatic for American policymakers and economists that the Depression must consequently have had its causes in the policies pursued after the stock market crash. One of the consequences of this generally accepted verdict has been a total lack of interest to probe more deeply into the intricacies of the boom phase. As a result, knowledge about eventual abnormalities during this phase is generally abysmal, even among leading American economists.

Actually, the Fed moved quite fast in light of earlier experience, slashing its discount rate from 6% to 2.5% within one year. The first steep fall of stock prices lasted little more than two weeks, from Oct. 24 to Nov. 13, 1929, from where it sharply recovered until April 1930.

After a pretty stable first half of 1930, during which stock prices rallied strongly, the economy suddenly slumped in the second half, even though the broad money supply had barely budged. As the following table shows, this sudden slump occurred across all demand components. To quote Joseph Schumpeter: *"Business operations contracted in the midst of a plentiful supply of 'money.'"*

Real GNP and Selected Components

(billions of 1929 dollars)

	Consumption	Investment	Construction	GNP	GNP Price Deflator
1927	73.2	15.6	10.4	97.3	101
1928	74.8	14.5	9.8	98.5	99
1929	79.0	16.2	8.7	104.4	100
1930	74.7	10.5	6.4	95.1	96
1931	72.2	6.8	4.5	89.5	85
1932	66.0	0.8	2.4	76.4	77

Source: Peter Temin, *Did Monetary Forces Cause the Great Depression?* 1976

With the euphoria about a "New Era" for the U.S. economy still virulent after the stock market crash, a quick recovery was generally expected. What strikingly differentiated this downturn from all forerunners was the sudden, sharp slump in consumer spending. Yet it was taken for granted that the Fed's rapid rate cuts would usher in economic revival.

A truly dramatic change in economic activity, and also in expectations, only began with the banking crisis of November–December 1930, acting to reduce the money supply. Escalating bank failures principally had their reason in declining market values of foreign, corporate and real estate bonds ravaging the banks' capital and lending power. The question is why asset prices fell — because of tight money or due to rising risk premiums as the quality of bonds began to be questioned?

NO "GARDEN-VARIETY" TYPE

It is the great merit of the proponents of Austrian theory to have uncovered and shown that the borrowing and spending excesses driving a boom may, with or without inflation, exert harmful economic and financial effects other than just a rising inflation rate — actually, more harmful effects.

In the postwar period, recessions in the industrialized countries were sharp and brief until the late 1970s. Limited spending excesses in inventories, business fixed investment, consumer durables and construction were liquidated within barely a year. In the United States, the typical recession for the postwar period has averaged one year, with a decline in real GDP by 2%. As soon as the Fed loosened its shackles, pent-up demand in the areas affected by credit restraint took off again, catapulting the economy to new heights.

Sometime in early 2001, Mr. Greenspan expressed the view that the unfolding recession was of the harmless "garden-variety" type. This used to be the popular label for the short "cyclical" recessions that had been typical of the whole postwar period.

Actually, the U.S. economy's downturn in 2001 had no relationship or similarity whatsoever to the customary "garden-variety" cycle. Credit growth, far from slowing down, accelerated as never before. An unprecedented slump in business fixed investment, plunging over the following eight quarters by 14.5%, acted as the single depressant.

But sharp increases of other demand components, propelled by prodigious fiscal and monetary stimuli, soon more than offset the slump in business fixed investment. Government spending increased by 9.2% during the same eight quarters. In the private sector, the Fed-engineered housing bubble boosted residential building (+7.2%) and consumer spending (+6%). The net result was America's shallowest recession, but what followed was the slowest economic recovery in the postwar period. Could there be a connection between the two?

Why the weakest recovery despite the most prodigious policy stimulus in history? If the economy's downturn was unique in its pattern, so also was the pattern of its upturn.

By the third quarter of 2005, real GDP had grown 14.1% since 2000. It had accrued from disproportionate gains in residential building (+36.5%), consumption (+17.3%) and government spending (+16%). The major adverse counterbalancing forces were sluggish business investment (+5.9%) and soaring imports (+23%).

Over the whole period, real GDP has grown at an annual rate of 2.9%. That is well below the average growth rate of 3.8% for previous postwar business cycles. Outright dramatic is the shortfall in employment and inflation-adjusted income growth. With all the phantom jobs from the "net birth/death," private sector jobs are just 1% higher than in December 2000, for which employment for defense spending played a significant role. For comparison, payroll jobs in past cycles have risen about 9% over the same time.

Essentially, this dramatic shortfall in employment implies a corresponding shortfall in income growth. During the three months to November 2005, real disposable incomes of private households exceeded their year-ago level by just 1.36%, as against 3.4% for real GDP.

Mr. Greenspan and other Fed members have never made a secret of their systematic efforts to create a panoply of new asset bubbles after the equity bubble popped. Among their policy novelties was the repetitive public assurance to keep their short-term policy rate at a rock-bottom level for as far as the eye can see as incentive for carry trade, particularly for long-term bonds, and as the key condition for inflating asset prices.

Enraptured financial institutions promptly obliged by driving long-term rates and credit spreads to record lows through heavily leveraged carry trade. For the consensus, this represented a highly successful monetary policy that had bowed to no rules.

In hindsight, they hail the many achievements: enormous "wealth creation" through rising house prices, record-high productivity growth, stable and comparatively strong economic growth and the mildest postwar recession in the wake of the bursting equity bubble in 2001.

It makes an impressive list — only a very incomplete one. It ignores a variety of economic and financial inflictions causing and reflecting extremely unbalanced economic growth. This negative list begins with the savings collapse and the monstrous trade gap, and it continues with the housing bubble and the surge of consumption as a share of GDP. Last but not least, it must be taken into account that this subpar economic and income growth has involved an unprecedented credit and debt orgy.

However, with the general focus very strongly on the low core inflation rate, Mr. Greenspan earned a reputation for being America's greatest inflation fighter, which, in turn, is supposed to have laid the foundation for the stellar rate of productivity growth and the extraordinary steadiness of economic growth.

INFLATION — ONE CAUSE AND THREE OUTLETS

Pondering the role of inflation, we have to start with the crucial distinction between the cause and the effect of

inflation. There is always one and the same cause, and that is credit excesses, defined as credit expansion in excess of available savings. By this measure, Mr. Greenspan easily ranks as America's greatest inflationist of all time.

The gross misconception of him as a rigorous inflation fighter derives from the protracted fall of the inflation rate for goods and services during his regime, which actually occurred around the world.

What really is the essence of "inflation"? Generally speaking, it is credit excess fueling spending excess. Most of the time, this has led to spending excess on current goods and services, inflating their prices. This was, in fact, the rule around the world until the late 1970s — a world, by the way, virtually without trade deficits.

But in the 1980s, this began to change in several countries, particularly in the United States. While money and credit growth sharply accelerated, the inflation rate for goods and services declined. It was already hailed as a miracle of Reaganomics. In reality, it had a mundane reason: The inflationary spending excesses had changed direction from domestic goods and services toward asset markets and foreign producers.

To pinpoint the decisive aspect: Inflation has one single cause, and that is credit excess. However, its distribution in the economy is not fixed. There are principally three different potential outlets: goods and services, asset markets and imports.

What happened in the United States and several other countries, starting in the early 1980s, is that a growing part of the accelerating money and credit flows poured into asset markets, inflating their prices, and into the imports of goods, inflating trade deficits, with their counterpart in "disinflation" of consumer and producer prices.

The "New Bubble Era" had begun for several countries, taking most experts completely by surprise. Yet a study titled "Monetary Policy, Financial Liberalization, and Asset Price Inflation" by the International Monetary Fund, published in its *World Economic Outlook*, April 1993, perfectly pinpointed the key cause of this new inflation pattern — ***"a credit expansion in excess of the expansion of the real economy."*** It went on to say:

> *Financial liberalization, innovation and other structural changes in the 1980s created an environment in which excess liquidity and credit were channeled to specific groups in the markets. These include large institutions, high-income earners and wealthy individuals, who responded to the incentives associated with the changes. These groups borrowed to accumulate assets in global markets — such as real estate, corporate equities, art and commodities such as gold and silver — where the excess credit apparently was recycled several times over.*

And here is one of the conclusions of this study:

> *To the extent that asset price changes are related to excess liquidity or credit, monetary policy should view them as inflation and respond appropriately. There is nothing unique about asset markets that would suggest that asset prices can permanently absorb overly expansionary policies, without leading to costly real and financial adjustment.*

Since 2000, total credit in the United States has expanded by $9 trillion. Over the same period, inflation-adjusted GDP has increased $1.4 trillion. The comparison with real GDP growth makes sense because, ultimately, debt service has to be paid from inflation-adjusted income.

IT IS AN OLD DISPUTE

This question of how to define inflation has always been in dispute. Webster's says, "Inflation is an increase in the volume of money and credit relative to available goods" and "Deflation is a contraction in the volume of money and credit relative to available goods."

The Collected Writings of John Maynard Keynes documents an interesting exchange of views on this subject between him and leading American economists at the time. It developed out of a discussion within the board of the National Mutual Life Assurance Company, of which Keynes was chairman. One member of the board, O.T. Falk, warned his colleagues in 1928 that the United States had serious inflation, which would force the Fed to a policy of tight money. If the Fed did not so act, there would be a severe reaction from current stock price levels. Falk

recommended selling the bulk of the company's holdings of American securities.

Keynes, quite irritated, responded with a paper he sent for comment to various leading British and American economists, among them members of the New York Fed. His chief point in this paper was this:

> *Inflation — put broadly — means that, for some reason or another, the stream of consumers' buying is increased faster than the stream of finished goods available for them to buy, with the result that prices rise. It is not convenient to mean by it anything else… If there is inflation, it must show itself sooner or later in rising prices for articles of common consumption.*

W.R. Burgess answered for Governor Benjamin Strong of the New York Fed:

> *Governor Strong has been laid up at his apartment almost continuously… He discussed your letter with me yesterday and "asked me to acknowledge it and tell you that he read the memorandum with the greatest interest, but has found in it so many points where he believes either your facts or your conclusions are wrong that, with his limited strength, it would be too much of a task to attempt a reply."*

Instead, Keynes got a lengthy and precise answer from another member of the New York Fed, Carl Snyder. Here are some extracts from this letter:

> *Owing to the abundance of credit, in excess even of what appears to be about the maximum possible growth of trade, there came a heavy expansion of bank investment… The buying, of course, gave a tremendous fillip to the stock market, and there ensued a corresponding expansion of speculative loans… accompanying the greatest rise in stock prices which this market has ever seen…*
>
> *All this has been accompanied, partly in consequence of the abundant credit, by what appears to be the greatest building boom which this country has known in 60 years… What we know is that a large part of this tremendous building has been purely speculative and that, so great has been the supply of credit, speculative builders have been able to mortgage hotels, apartment houses and office buildings for more than the total cost of construction… All this has resulted in a serious inflation of real estate values…*

A particularly interesting answer came from professor Charles Bullock, the principal of the Harvard Economic Service:

> *I do not see the propriety of limiting the word "inflation" to commodity price inflation. Of course, its use in economics was originally purely figurative, and I don't know now that we have any standard definitions to go by; but nothing in the etymology or history of the word "inflation" justifies us in limiting it to commodity prices… I am not ready to say that it is the only kind of inflation that is significant.*

Mr. Falk reversed his 1928 arguments and turned bullish for U.S. stocks. After heavy stock purchases in the summer of 1929, the firm, and he himself, suffered huge losses. To meet his personal losses, Falk had to sell his country house. Keynes, by the way, had speculated only in commodities at the time, not in stocks.

Keynes, too, reversed his opinion, in opposite direction to Falk. In his *A Treatise on Money*, first published in 1930, he commented on a table about bank credit, the wholesale price index and stock prices thereof as follows:

> *Anyone who looked only at the index of prices would see no reason to suspect any material degree of inflation; whilst anyone who looked only at the volume of bank credit and the prices of common stocks would have been convinced of the presence of an inflation actual or impending. For my own part, I took the view at the time that there was no inflation in the sense in which I use this term. Looking back in the light of fuller statistical information than was then available, I believe that, whilst there was probably no material inflation up to the end of 1927, a genuine profit inflation developed sometime between that date and the summer of 1929.*
>
> *The index of wholesale prices was misleading because this index is much influenced by the international price level, and in the rest of the world there was from 1926 onward a deflation.*

We have recalled this episode because a proper assessment of "inflation" is, in fact, of paramount importance for

identifying policy mistakes. Plainly, thinking on this issue was much more profound at the time than it is today, with the narrow focus on consumer prices. In particular, the causal connection with credit excess was well understood.

TIMING THE POLICY MISTAKES

The pivotal question about both the U.S. Great Depression as well as Japan's protracted economic near-stagnation is when exactly the central banks committed their decisive mistakes. In the United States, was it when accommodating credit excess in the late 1920s, before the equity crash, or was it when loosening credit reins too slowly after the crash?

Or in the case of Japan: When exactly did Japan's economy catch its paralyzing disease? Was it during the boom years of 1986–89, owing to debt excesses and misdirection of resources during the boom years? Or did the economy catch its virus of protracted near-stagnation after the stock and land bubbles had burst, because the central bank eased too slowly?

Japan's dismal economic experience almost 15 years after the bust of its bubbles has given occasion for a vivid exchange of opinion between international experts about its causes, particularly between American and Japanese experts. While the discussion may seem highly theoretical, it definitely provides clues for the future.

THE AMERICAN VIEW

The Federal Reserve has taken part in the discussion with research of its own, including a study titled *Preventing Deflation: Lessons From Japan's Experience in the 1990s*, published in June 2002.

Not quite amazingly, the American experts come to conclusions virtually in line with the conventional explanation of the U.S. Great Depression. Yet the Fed's paper elaborates two major adverse effects as the heritage of the asset and credit bubble: *first*, a substantial capital overhang from prior excessive investment; and *second*, severe damages to the balance sheets of firms and financial institutions from plunging stock and land prices.

However, it concludes:

> *Even so, our sense is that Japan's financial difficulties were very unlikely to have fully eliminated the impact of monetary policy on credit and spending…*
>
> *The failure of the Japanese economy to revive in the 1990s, even after substantial declines in real short-term interest rates, raises concerns about whether Japanese policy might have lost its ability to influence the economy during this period. While evidence on this issue is not fully conclusive, our sense is that much of the failure of monetary loosening to support asset prices and to boost the economy owed to offsetting shocks, rather than to a genuine breakdown of the monetary transmission mechanism. The "financial headwinds" associated with the collapse of asset prices probably did, to some extent, hinder the ability of monetary policy to boost activity. Additionally, especially after 1995, Japan did exhibit symptoms suggestive of a "liquidity trap." Even so, there is little evidence that the transmission channels of monetary policy were so diminished as to have obviated the benefits of faster and sharper monetary easing in the 1991–95 period.*

But what are the probable "offsetting shocks" that robbed the central bank's monetary easing of part of its effectiveness? What else could this be than the collapse of the grossly inflated asset prices that prior monetary looseness had fueled?

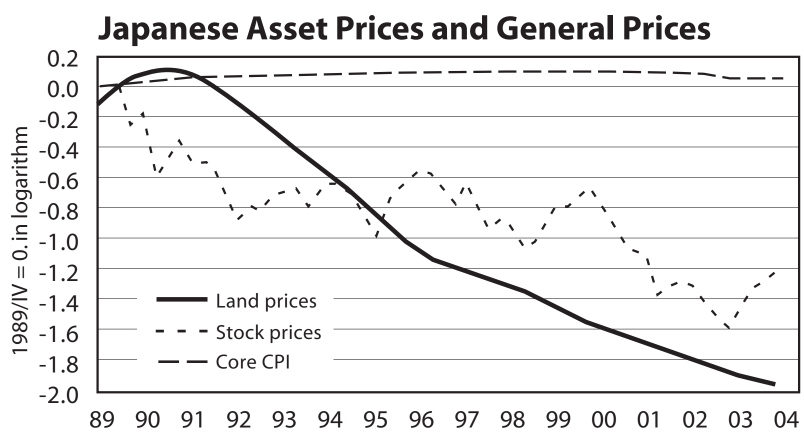
Ultimately, the Fed study ascribes Japan's persistent economic stalemate to flawed strategies in monetary and fiscal policies after the asset crashes and the failure to *"take out sufficient insurance against the downside risks through a precautionary further loosening of monetary policy."*

THE JAPANESE DISAGREE

The Japanese experts too identify ruinous deflation in their country, but with a diametric difference to American observers. In their opinion, the decline in the consumer price index by less than 1% per year has been much too

moderate to explain the Japanese economy's near-stagnation since 1990.

Japanese experts, in short, categorically attribute their protracted economic calamities to two legacies from the "bubble" period: *first*, devastated balance sheets both of banks and corporations through the collapse of asset values as against record-high debts; and *second*, a profit-depressing gross capital overhang from the prior investment excesses. They see a protracted "balance sheet recession." This implies, of course, that the present calamities have their root cause in the asset and credit bubbles created far back during the prior boom.



Source: Bank of Japan, "Financial and Economic Statistics Monthly", December 2004

Official Japanese calculations put the combined capital gains on stocks and land during the bubble years of 1986–89 at 452% of GDP. The Nikkei stock index at end-1989 hit a peak of 38,915, more than three times its level at the time of the Plaza Agreement in September 1985. The Urban Land Price Index reached its peak in September 1990, almost four times its level in September 1985. Considering these immense capital losses, it may seem remarkable that the Japanese economy has not performed even worse than it actually has.

For the experts of the Bank of Japan, it is beyond question that the economy's troubles have their root cause in the emergence of the bubble economy, rather than in its bust. Importantly, they further admit that **"The magnitude of damage caused by the bursting of the bubble is disproportionately larger than the gains obtained in the emergence of the bubble."**

The decisive point to see is that the crucial economic and financial damages occur because the inflating asset prices lead to grossly lopsided spending, implying corresponding distortions in the structure of production.

In Japan's case, the structural distortion consisted of the fact that business fixed investment and construction in commercial real estate soared out of proportion to the economy's long-term trend of economic growth. Between 1986–1990, business fixed investment surged by 55%. As a share of GDP, it escalated from 14.5% to 20%.

At the time, Japan's "New Paradigm" economy was the envy of the world. It was top among the industrialized countries by any measure. It had record-high growth, record-high savings, record-high investments, a record-high export surplus and a record-low inflation rate in consumer and producer prices.

Yet the central bank looked at the soaring asset prices and the booming economy with growing misgivings. One of its research papers says:

> *When we look back to the start of monetary tightening in 1989 and the experience thereafter, we now feel that we should have applied the brakes on the excessive boom much earlier. However, back in those days, as prices were not rising, it was difficult to obtain people's understanding for a policy aimed at achieving a sustainable growth of the economy through monetary tightening.*

ASSESSING THE BUBBLE DAMAGE

In the book *Valuing Wall Street*, Andrew Smithers and Stephen Wright say the evidence of history *"suggests that allowing asset bubbles to develop is the greatest mistake that a central bank can make."*

This is our strongly held opinion, ever since we have studied the U.S. economy's "New Era" years of the 1920s. The first book to acquaint us with the idea of an asset bubble was *The Twilight of Gold, 1914–1936*, by Melchior Palyi, published in 1972. He emphasized the dangerous interaction between credit and asset inflation driving the boom during the 1920s and the following painful asset and debt deflation.

It should be clear in the first place that the potential damages to the balance sheets both of lenders and borrowers through the collapse of collateral values may, according to scale, go a long way to strangle economic activity. To discard this flatly as a headwind of limited importance, as the Fed study does in the case of Japan, is bizarre.

The second adversity implicitly accruing from an asset and credit bubble are the associated distortions in the economy's resource allocation between consumption and investment, associated with runaway debt growth.

In Japan's case, the main content of the bubble was a dramatic rise in capital expenditures. In the present U.S. case, by contrast, the main content of the bubble is a dramatic increase in consumer spending.

What precisely went wrong in the case of Japan? With their eyes glued on the inflating stock and land prices and the booming economy, Japanese corporations were slow in realizing that their soaring debts were financing a growing capital overhang both in manufacturing fixed investment and in commercial real estate, destined to deflate their future profits. Too great a share of the investment boom ended up in profitless malinvestments. Earlier monetary tightening would, of course, have limited this structural damage.

But what, then, has been thwarting a more robust recovery of Japan's economy for 15 years now? Is it all about the speed of interest rate cuts? Or is it about the immensity of the task of unwinding the financial and structural damages from the prior credit excess?

The Japanese experts see the basic cause of the protracted economic stagnation in the need to unwind enormous excesses in capital, labor and debt built up during the boom years. Balance sheet and liquidity problems, as well as the sharply slower economic growth, on the other hand, also immensely hamper this restructuring process by lowering the effectiveness of monetary policy. In other words, the experts think that the Bank of Japan is pushing on a string. It is hard to believe that somewhat faster rate cuts would have made all the difference.

AND NOW TO THE U.S. BUBBLE ECONOMY

Faced with the popping equity bubble and a sharply slowing U.S. economy, and fearful of a Japanese-like post-bubble carnage, in 2001 the Fed slashed its policy rate in quick succession by 475 basis points. The government joined this most massive monetary stimulus with a massive fiscal stimulus. For the consensus, these policies, virtually determined by Wall Street, have been a great success.

Compared to Japan's post-bubble policies, it certainly appears a smashing success. There is no secret as to how the Greenspan Fed pulled it off in 2001: It was all about replacing the bursting equity bubble with an array of other bubbles, enabling the American consumer to maintain his spending binge by an ever-larger borrowing binge, while real disposable incomes increasingly lagged.

There is good and bad economic growth. What matters is the underlying impetus and the mix.

It is peculiar to a bubble economy that monetary policy operates through inflating asset prices. It then depends on which asset markets and which kind of spending respond. The main recipient of the credit excess has been the consumer. The most striking repercussions between 1995–2000 were the collapsing personal saving rate and the exploding trade deficit.

And what has happened to the economy's mix after 2000? In short, all the structural distortions and imbalances that had accumulated during the prior boom have gone from bad to worse, and far worse. The personal saving rate has plunged into negative territory, while the U.S. trade gap has almost doubled again.

Personal debts have skyrocketed from $6.9 trillion in 2000 to $11 trillion in the third quarter of 2005, up 60%. As to real disposable income, its growth lately is down to 1.4% year over year, from 3.6% in the late 1990s. Debt is exploding, while income is imploding.

Nevertheless, the consensus sees the U.S. economy in excellent shape. The main reason is that many American economists, if not most, are not trained to see any other problem than a rising inflation rate. Saving is superfluous in the face of rampant wealth creation through rising stock and house prices, and the huge trade deficit, far from reflecting a U.S. credit and spending excess, is emblematic of the U.S. economy's superior performance and the

eagerness of foreigners to participate by investing in the United States.

From the "New Paradigm" mantra of the late 1990s to today's new theories about the positive origins of the trade deficit, American economists have, under the guidance of Mr. Greenspan, turned long-established macroeconomic insights upside down in order to convince market participants of the wisdom of the new policies. Remarkably, they have a highly receptive, totally uncritical audience.

HOLLOWING OUT U.S. MANUFACTURING

What, then, is wrong with the U.S. economy? At first sight, there exist five obvious major structural defects: the record current account deficit, the collapse of national saving, record-high household debts, lagging business fixed investment and badly trailing employment and income growth.

The decisive structural maladjustment is a gross imbalance between consumption and business investment. Helped first by the equity bubble and then by the housing bubble, the consumer has taken a growing share of GDP at the expense of business investment and net exports. With this unusual mix, the economy never gained the traction for self-sustaining growth.

For the bullish consensus, it is a token that "pent-up" investment spending is going to burst forward and assure the U.S. economy's further strong growth. For this to happen, it is, first of all, rather late in the recovery, and second, impending sharply slower consumer spending will hardly inspire higher investment spending. The great probability is their joint downturn.

The most obvious other major drag on U.S. economic growth is the monstrous trade gap, now equal to more than 6% of GDP. Determined to see nothing wrong in the U.S. economy, the consensus economists entertain two comforting thoughts: *First*, it does not matter; and *second*, Asian central banks will always accommodate it in their own strong interest.

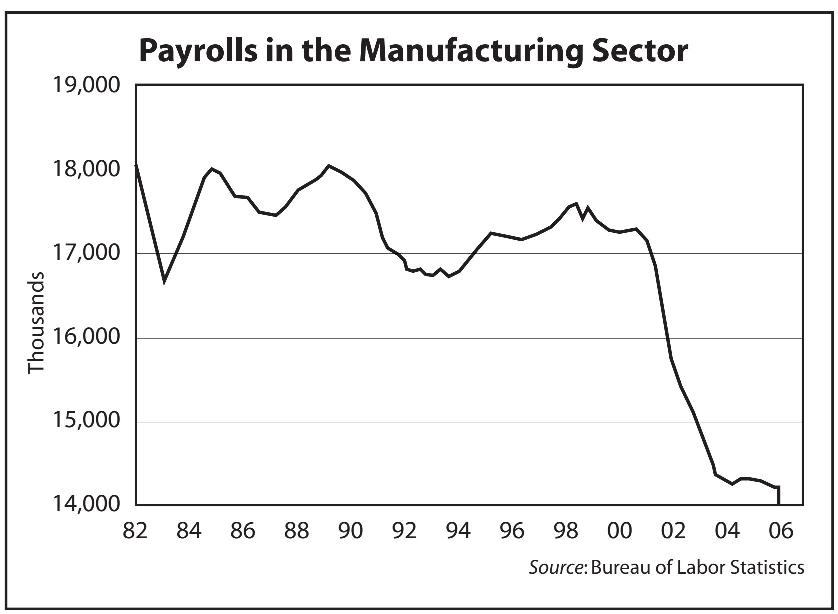
America's own interests are another question, of course. What American policymakers and economists apparently like about the trade gap is that large, cheap imports tend to cap the U.S. inflation rate. Also, it appears to be greatly esteemed that the lower inflation rate is helpful in lowering U.S. interest rates.

The question of implicit costs to the U.S. economy appears to be beyond general interest and understanding. There seems to prevail a comforting perception that the money flowing out through the trade deficit promptly comes back.

It does, indeed, but only in terms of dollars. In terms of economic effects, they differ diametrically. The money departing through foreign trade balance exits the job-creating internal spending-and-income circuit, while the money, returning through the capital account, only buys U.S. assets, involving no spending on goods and services in the U.S. economy.

Thus, the trade deficit exerts a dollar-for-dollar drag on U.S. economic growth. Not only that, this spending-and-income drag is concentrated on manufacturing.

U.S. producers are losing out to foreign producers. Of each dollar the American consumer spends, 40 cents now goes to foreign producers, against 25 cents in 1997 and 15 cents in 1991. America's unusually poor employment performance over the last several years manifestly has its cause in the



millions of job losses in manufacturing.

For the happy-go-lucky consensus, the U.S. trade deficit mainly reflects stronger U.S. economic growth. That Asian countries, China in particular, are running big trade surpluses with much stronger economic growth than the United States escapes them. In reality, what crucially matters is the relationship between domestic growth in demand and supply.

Trade surpluses are typical of countries with a strong supply side, characterized by high savings and capital investments. Trade deficits are typical of countries with strong demand creation but a weak supply side, characterized by low savings and low investments. Growth differences are comparatively minor.

The monstrous U.S. trade deficit, which has built up over virtually two decades, is essentially a structural problem. Basically, it has two main reasons: persistent demand inflation versus progressive investment deflation in the United States.

Historically, America has always been notorious for low rates of saving and investment, as opposed to a high rate of consumption. But from the perspective of economic growth, this negative structural mix has gone to unprecedented extremes in the past few years.

This unprecedented consumer borrowing-and-spending binge has been made possible first by the equity bubble and then by the housing bubble. America is not alone in this pattern. But it is alone in the world in that even its policymakers, above all Mr. Greenspan, hail asset inflation as "wealth creation." Apparently, most Americans need this illusion.

In hindsight, Mr. Greenspan is criticized for his unwillingness to do anything to fight the bubbles. The fact is he wanted them and deliberately created them in the conviction that their benefits would vastly outweigh the damages of their busts, being contained by loose money.

THERE ARE ENORMOUS RISKS

His argument that bubbles are impossible to identify before they burst was always preposterous. Their highly visible symptom and cause is erupting credit. In the United States, credit exploded. In the two most famous historical cases of bubble economies — the 1920s–1930s in the United States and the 1980s–1990s in Japan — damages in their aftermaths have proved far bigger than prior benefits. The net effect has been prolonged economic and financial disaster, outweighing the prior benefits many, many times.

The most important question now is whether house price inflation will be followed by house price deflation. The bullish consensus assumes that large untapped housing equity will keep the consumer borrowing-and-spending binge alive.

Essentially, this assumes avoidance of falling house prices. Even slowly declining prices, though, will put the numerous highly leveraged owners under growing pressure to dump their property, precipitating thus their decline.

Considering further the steep rise of debt levels in consumer balance sheets and the lamentably slow internal income generation, there can be no mistaking the existence of enormous risks in the housing market.

Moreover, the negative savings rate is prone to boomeranging. As the illusions of housing wealth dissolve, the consumer will willy-nilly return to saving out of current income. With real disposable income growth already in negative territory, even a very small rise in the savings rate would drive consumer spending into absolute decline.

While Mr. Greenspan with his unusual policies prevented a deeper recession in 2001, the relevant question to ask is whether the U.S. economy is in better shape for future growth today than it was at that time. The answer could not be more certain, and more negative: In terms of economic and financial foundations, the U.S. economy is in terrible shape today, actually its worst in history — far worse than in 1929.

OMINOUS SIMILARITIES

Though we dislike admitting it, we have in common with Mr. Bernanke that we both have carefully studied the U.S. boom-bust of the 1920s–1930s. However, our focus was on troubles accumulating during the boom years.

As the quoted Keynes correspondence shows, there was distinct concern in the Fed about an *abundance of credit* in relation to maximum possible trade growth, fueling *the greatest building boom* and *the greatest rise in stock prices*. In today's parlance, total bank credit growth exceeded GDP growth.

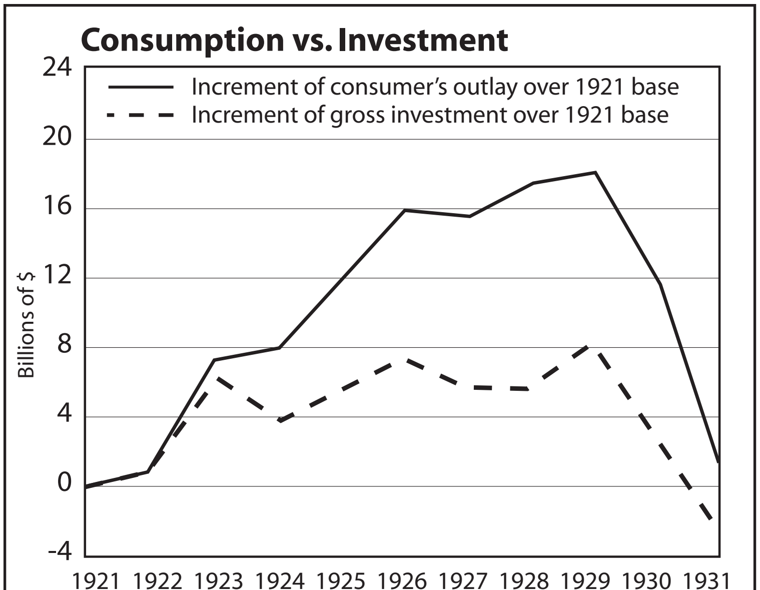
Both business investment and a construction boom in commercial real estate peaked by 1926–27. Then, in the summer of 1927, something unusual happened. There was a secret meeting of New York Fed Governor Benjamin Strong and the heads of three European central banks: Montagu Norman (England), Charles Rist (France) and Hjalmar Schacht (Germany).

The reason for the meeting was a plea from the British for a rate cut by the other three to support the ailing British pound. Schacht and Rist refused, telling their British colleague to restrain credit excess. Only Strong obliged. Combined with a sharp increase in their purchases of government securities, Federal Reserve banks reduced their rediscount rate from 4% to 3.5%. Presumably, though, they also responded to signs of a slowing U.S. economy.

Business investment and construction at this time had definitely passed their peak, suggesting an end to the economy's expansion (see table on Page 2). However, the whole time, there had been an exceptional feature to the U.S. economy's growth: More than 80% of the increase in GDP since the early 1920s had derived from consumption.

This monetary easing had amazingly prompt and strong effects — diametrically different, however, from normal experience. A virtually exploding stock market imparted a tremendous boost to consumer spending, while investment and construction remained motionless. During 1928–29, consumption accounted for total GDP growth.

The soaring stock prices were certainly a main reason for the unusual surge in consumer spending. But in addition, it was fostered by a novelty — escalating consumer credit. By the late 1920s, about 1,500 finance companies competed with the commercial banks for installment credits.



Source: Alvin H. Hansen, *Business Cycles and National Income*, 1951

It has always intrigued us how the U.S. economy and its financial system could virtually collapse in the early 1930s if they were in healthy conditions. To explain the rapid collapse with slow rate cuts after 1929 has always struck us as bizarre. For such a collapse to happen, an economy and financial system must have been in terrible shape.

Friedrich Hayek wrote, in *Econometrica (*April 1934), that the events after 1927 led to the Depression in the United States. The specific events, according to our findings, were the boom-busts of the equity and associated consumption bubbles.

It has been typical of recessions in all industrial countries that consumption has always acted as a stabilizer, while investment and construction turn down. In 1930 and the following years, for the first time, the opposite happened. As the artificial stimulus to consumer spending from the equity boom vanished, slumping consumer spending drastically aggravated the downturn. It is our long-held view that this was one main cause of the Depression's severity.

The second massive drag came from a highly fragile financial system, which had funded the asset bubble through disproportionately large purchases of corporate bonds, loans on securities and real estate loans.

As asset prices slumped and the economy sharply slowed, the credit pyramid collapsed. It took just three years to wipe out all of the credit inflation of 1922–1929. Total bank loans and the investments of commercial banks at end-1932 stood at a lower figure than during the recession of 1920–21.

WHERE ARE TODAY'S RISKS?

We have recapitulated Japan's and America's past disastrous bubble experiences in order to make three things poignantly clear: *First*, all asset bubbles are the product of credit inflation; *second*, the two worst bubble experiences in history have developed against the backdrop of virtual price stability; and *third*, both central banks made their obvious crucial mistake in focusing on low inflation rates and ignoring ongoing credit and asset inflation.

To this, we want finally to add a fourth point: America's credit inflation since 2000 is the worst in history, as measured by credit growth relative to GDP growth. In essence, the Greenspan Fed replaced the prior bad equity bubble with a much bigger and much worse housing bubble.

The specific effects of credit inflation on the economy and the price system depend on the places where the credit deluge enters the economy. In Japan's case, it grossly overexpanded construction and business fixed investment. In the U.S. case of the 1920s, it overexpanded consumer spending. Today, the unsustainable excesses are concentrated in consumption and housing.

There is a widespread perception that the U.S. economy under the Greenspan Fed has gained unprecedented steadiness. In actual fact, U.S. economic activity has become dependent as never before on rising house prices facilitating unbridled consumer borrowing. This may temporarily create a semblance of economic stability and strength. The reality is an extremely vulnerable economy and financial system.

CONCLUSIONS:

The U.S. economy's recovery from the 2001 recession has peaked. It has been running on a single engine: the housing and mortgage refinancing bubble powering a consumer borrowing and spending binge on consumer durables and housing. Overall consumption and residential building over this period accounted for 88.4% of real GDP growth.

There is but one serious question about the U.S. asset and credit bubbles, and that is how quickly and painfully they will end. According to reports, there has been reckless borrowing and lending at a very vast scale, suggesting great trouble ahead. Growth of business investment is much too slow to take over.

The thing to realize is that America's great inflation today, as in the 1920s, is in the asset markets and the financial system. The other big outlet, as explained, is the trade deficit.

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